Service Date: November 30, 1987

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER of the Application of AT&T COMMUNICATION OF THE MOUNTAIN STATES, INC. for Interim and Final Authority to Increase its Rates and Charges.	UTILITY DIVISION DOCKET NO. 86.12.67 ORDER NO. 5274a

FINDINGS OF FACT

Procedural Background

On December 12, 1986, AT&T Communications of the Mountain States, Inc. (AT&T) filed an application to increase its revenues by $3,165,000 annually. This filing was based on eight months of actual 1986 data annualized to represent twelve months.

On February 27, 1987, AT&T filed a revised application using a twelve month historical test year ending December 31, 1986. AT&T's revised request for increased annual revenues was $2,688,000. AT&T requested interim approval of these rates and agreed to November 28, 1987, as the expiration of the 9 months in which the Commission must act pursuant to Section 69-3-302, MCA.

On May 1, 1987, AT&T filed its rebuttal testimony in this docket. AT&T revised its revenue request to $1,959,000 in this testimony.

The following parties intervened in this docket:

Montana Consumer Counsel (MCC)

MCI Telecommunications Corporation (MCI)

General Telephone of the Northwest (GTNW)

Montana Telephone Association (MTA)

Telecommunications Bureau, Dept. of Admin.
Northwestern Telephone Systems (NWTS)
Mountain Bell (MBT)

On March 24, 1987, the Commission issued an amended procedural order allowing parties to file testimony on the question of detariffing AT&T service on a route specific basis if functionally equivalent long distance service were available from an alternative provider. AT&T, MCI, NWTS, and MCC filed testimony. MBT and MTA informed the Commission that they were not going to file testimony of the issues raised in the amended order.

On July 1, 1987, the second year of the carrier access charge changes set forth in Docket No. 84.4.15, Order No. 5055g took place. These changes significantly decrease the amount AT&T pays the local companies for access to their networks. Order No. 5055g required AT&T to reduce its rates to offset the decreased carrier access charges.

On June 8, 1987, the Commission issued Order No. 5236c in Docket No. 86.11.62. This order required utilities to give effect to the reduction in federal income taxes pursuant to the Tax Reform Act of 1986. Order 5236c set forth generic methodology to be used to calculate the changes in revenue requirement occasioned by the Tax Reform Act. Interim Order No. 5276 was issued for AT&T in that Docket.

On July 1, 1987, the decrease in Order Nos. 5055g and 5276, and the increase granted in this Docket, Order No. 5274, were implemented simultaneously. This resulted in a net decrease of $1,064,415.

Following proper public notice, a hearing was held beginning July 15, 1987. At the hearing, AT&T decreased its revenue requirement to $1,952,000. Appearing at the hearing were AT&T, MCC, MCI, GTNW, MTA, NWTS and MBT. AT&T had requested and the Commission had issued a protective order in this docket. The protective order was later amended to accommodate discovery and to continue to protect AT&T's proprietary interest in confidential information. During the hearing parties asked that portions of the hearing be closed, according to the procedures established in the protective order, to protect proprietary information.

Rate of Return

Steve Vinson testified on behalf of AT&T on Cost of Capital issues. Vinson recommended the Commission continue the currently authorized 12.08% rate of return. Vinson presents AT&T's current overall cost of capital using the following structure and capital costs:

AT&T (Consolidated)

Debt	33.56%	7.40%	2.48%
Pref. Stock	3.76%	7.48%	0.28%
Common Equity	62.68%	15.10%	9.46%
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	100.00%		12.22%
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AT&T Communications

Debt	27.37%	6.68%	1.83%
Equity	72.63%	15.10%	10.97%
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	100.00%		12.80%
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Vinson examined the cost of equity to AT&T by attempting to arrive at a cost of equity for two groups of comparable companies. As one broad group with comparable risks, Vinson used the Standard and Poor's 400 industrials. He also selected a group of companies with debt ratings and income volatility comparable to those expected for AT&T. Vinson computed a discounted cash flow cost of equity for these companies. These companies cost of equity ranged between 15.1 and 15.3 percent.

Caroline Smith testified on cost of capital issues on behalf on MCC. Smith recommended an overall rate of return of 10.50% based on the following capital structure and costs:

Debt	40.00%	7.40%	7.50%
Equity	60.00%	12.50%	3.00%
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	100.00%		10.50%
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Smith noted that there was not yet enough actual data to perform a DCF analysis for AT&T. As a proxy, Smith presented a DCF analysis of telephone utilities in general and then adjusted the results to reflect AT&T's somewhat higher risks. Smith also reviewed the comparable earnings levels for the unregulated sector and for other telephone utilities. Smith's DCF analysis of common equity costs in the telephone industry indicated a need for 10 to 11.5 percent. Adjusted for AT&T's somewhat greater risks, Smith recommended a 12.5 percent common equity allowance for AT&T.

The Commission does not agree with Vinson's use of companies that are "comparable" to AT&T. Certainly the risks of AT&T's Montana operations are not similar to those of unregulated major industrials. The competition AT&T faces in Montana is less than in other states. The Findings in this Order reveal that AT&T faces inadequate competition to justify a large departure from treatment as a typical monopoly utility. The cost of equity granted by the Commission for AT&T's Montana operations should reflect the lesser risks faced by AT&T in Montana. The Commission, therefore, did not place heavy emphasis on Vinson's testimony in examining the cost of equity in this Docket.

Smith criticized Vinson's use of short-term growth estimates. (Exh. MCC-1, p.18) However, an examination of the historic growth rates Smith used to predict the growth in dividends used in DCF calculations, show Smith averaged growth rates ranging from one year to ten years. The DCF model called for the long-term expectations of investors. If the ten years 1976 to 1986 are used, the average growth in dividends, book value, and earnings is 6.3%. This growth rate added to the current divi dend yield for these companies resulted in a cost of equity of approximately 12%.

The Commission agrees with Smith and Vinson that AT&T faces substantially more risk than the average basic telephone utility. In the past, the Commission has assumed the risk on monopoly telephone operation to be similar to those in the electric industry. Current rates of return authorized by this Commission for the electric industry have been in the 12.3% to 12.5% range. The Commission finds that an appropriate cost of equity related to its Montana operations is 13.25% This is 75 to 95 basis points higher than recent returns granted by the Commission and 125 basis points higher than the 12% discussed above.

Vinson recommended using the actual capital structure for AT&T's consolidated operations or AT&T Communications (See FOF 10). Smith recommended the use of a 60% equity ratio. Smith pointed out that this equity ratio is "less equity rich than is typical of large, representative groups of industrial companies and is more equity rich than the capital structures of regulated utilities. To the extent that ATTCOM is more risky than other regulated companies, a somewhat higher common equity ratio and/or common equity return are appropriate." (Exh. MCC-1, pp. 7-8) The Commission agrees with Smith that this capital structure is appropriate for AT&T's Montana operations. This capital structure is significantly more equity rich than the currently authorized Mountain Bell capital structure of 50% equity or electric and gas capital structures of 35% to 40% equity.

The Commission finds that AT&T's overall rate of return is 11.21% as follows:

Debt	40%	7.4%	2.96%
Equity	60%	13.25%	7.95%

			10.91%
			======

Revenue Requirements

AT&T's original revenue requirement reflected a rate base addition of $1,763,000 for cash working capital. MCC offered testimony concerning several working capital issues. AT&T's rebuttal testimony concurred with all but two of these adjustments and revised the cash working capital rate base to $1,366,000. The first disputed adjustment is the lag on "other expenses". AT&T computed a 10.17 day lag by averaging the computed lags for wages, relief and pensions. MCC stated that this approach is unreasonable because there is no apparent reason for other expenses to have a lag that is significantly shorter than the average cost of service item. MCC adjusted this lag to equal the average for the other cost of service items.

AT&T filed rebuttal stating that this adjustment is improper because the "other cost of service items" include state income tax with 364.48 lag days, gross receipts tax with 223.06 lag days, and property tax with 338.91 lag days. The Commission agrees with AT&T that the lag days used in rebuttal, which use an average of access, billing, wages and salaries, depreciation, operating rents and relief and pensions, are appropriate for this item.

The second disputed adjustment is MCC's recommendation to eliminate the $1.1 million contract-related working capital allowance proposed by AT&T. MCC's witness Kirby testified that AT&T failed to provide a lead-lag study or any other valid analysis to support the existence of a cash working capital requirement related to contracts. Kirby noted that AT&T receives "float" revenues that are supposed to reflect the return requirement associated with the cash working capital related to contracts. The float revenues are based on an incremental cost of capital, which for the test period was computed to be 13.6%. (Exh. MCC-2, pp. 18-20)

AT&T's rebuttal testimony explained that the float revenues are calculated by taking the expenses incurred for a given month and multiplying those expenses by the lag in the number of days before payment is received. This amount is then multiplied by the incremental cost of capital to determine the payment or float charge each month. AT&T witness Waller explained that a lead-lag study is not necessary because the float charge is based on a specific determination of the net lag between the time service is rendered by the contract facility and the time payment is received. (Exh. AT&T-4, pp. 10-12)

In Docket No. 83.11.80 AT&T attempted to exclude the float revenues based on the fact that cash working capital had not been included. The Commission, in Order No. 5044d included the float revenues because cash working capital as a whole had not been examined. The Commission, in FOF No. 20 stated that "If a lead-lag study had been presented in this case there is no evidence that the result would have been positive or negative." In this case, AT&T presented a lead-lag study. MCC agreed that the study shows that AT&T has a need for cash working capital. Therefore, in this case to include float revenues without recognition of the offsetting cash working capital component would be unfair to AT&T. The Commission is not concerned that an incremental cost of capital was used to determine the float revenues. Since the Commission included the cash working capital in rate base and grants an overall return on that amount, any revenues that represent a return in excess of AT&T's authorized rate of return reduce AT&T's revenue requirement.

AT&T's rebuttal testimony includes a tax rate of 34% and other effects of the 1986 Tax Reform Act. The Commission is examining the effects of the Tax Reform Act in Docket No. 86.11.62. The Commission finds that it is procedurally preferable to keep the effects of the Tax Reform Act separate. Therefore, the revenue requirement granted in this Order does not include the effect of the Tax Reform Act. Removing these effects increases revenue requirement by $162,000.

The Commission finds that AT&T has a revenue deficiency of $1,876,000 as follows:

Average Rate Base	$12,125
Rate of Return	10.91%
Required NOI	1,323
Adjusted NOI - Sch. 1	297
Difference	1,026
Net to Gross Multiplier - Sch. 2	1.6703
Revenue Deficiency	1,714
Rev. Req. of TRA	(162)
Revenue Requirement	1,876

This amount represents an increase of $188,000 over the interim revenue requirement.

MCC recommended that the Commission not accept AT&T's determination of private line costs and order the company to produce a current test year cost study with complete verifiable support. In this proceeding, AT&T removed private line revenues and costs. These calculations show significantly more costs have been removed than revenues. The Commission will accept AT&T's calculations for use in this case. However, the Commission is concerned with two cost accounting areas. The first is that the system used in this case is being revised by AT&T to meet the FCC guidelines set forth in Docket 86-111 (Trans. p. 52). The second area of concern is the level of documentation supporting the cost accounting system used. For instance, the work papers submitted to support the deregulated private line study simply state that the allocation of circuit equipment was based on a "circuit equipment factor from external affairs." Obviously, the Commission and intervenors need to be able to review exactly how all allocation factors are determined. In the next revenue increase application filed by AT&T, the company must submit its updated cost allocation manual including adequate backup documentation and work papers.

Reduced Regulation

Intervenors testifying on changed regulation and detariffing issues include the Montana Consumer Counsel, (MCC), Microwave Communications Inc., (MCI), and Northwestern Telephone Systems, (NTS). The following reviews the parties' proposals.

AT&T

AT&T submitted two reduced regulation proposals, one in its amended and another in its supplemental testimony. AT&T's amended testimony (Mr. Little) emphasized the need for price flexibility. AT&T's price flexibility involves the following forms of reduced regulation: 1) access charge pass through, 2) price indexing and 3) financial reporting.

With the access charge pass-through, AT&T's maximum allowable rates, (MARs), would reflect changes in carrier access charges. The rate indexing proposal would reflect Consumer Price Index, (CPI), changes in the MARs, but no more frequently than on a semi-annual basis. Any changes to MARs would be documented and copies provided to the Commission. Quarterly income statements would be filed with the financial reporting proposal.

At the hearing, AT&T testified on how the access charge and CPI pass through might operate (TR 242-246). The access charge flow through would be on a cost causal basis: only those price elements that caused changes in access charges would change. The CPI adjustment is, apparently, to MARs based on each MAR's makeup of non-carrier access costs. AT&T appears to concede that the price index adjustment should be net of productivity (technology) gains, but expressed difficulty with empirical measures (TR 243).

AT&T's supplemental testimony responded to the amended procedural order that requested parties to comment on route- and market-specific detariffing issues. This supplemental testimony proposed a different form of reduced regulation, and also appears to be a "detariffing" proposal (TR 382). AT&T proposes to withdraw those sections of its tariffs reflecting its rates for MTS, WATS and 800 Service, but retain those sections of its tariff on file that provide service terms and conditions. This proposal effectively allows AT&T total, but State averaged, pricing flexibility for certain services.

If granted this reduced regulation request, AT&T would commit to not geographically deaverage its Montana prices without prior Commission approval. AT&T would seek approval if: 1) access charges were deaveraged, 2) competitors deaverage prices or 3) customers demand deaveraged prices. AT&T noted that dissolution of the Montana Telephone Association TECOM access pool would not represent a deaveraging scenario (TR 236).

If the Commission rejects the supplemental testimony proposal, AT&T recommends the Commission adopt its amended testimony proposal.

To support its reduced regulation proposals, AT&T presented testimony from Dr. John Mayo. This testimony addressed interLATA competition possibilities and rebutted the MCC's testimony which argued to retain regulation of AT&T. Dr. Mayo's testimony is divided into four general parts.

First, Dr. Mayo compared criteria in the Montana Telecommunications Act (MTA) 69-3-801, MCA, et. seq. to the economic analysis of telecommunications markets. Dr.Mayo noted similarities between the MTA and economic criteria in terms of how markets should be analyzed, and in turn regulated. Based on three factors, including changes in 1) technology, 2) demand and 3) regulation, Dr. Mayo holds the interLATA telecommunications market is potentially competitive (AT&T Exh No. 8, p.8 and TR 340). Dr. Mayo stated regulation is not in the public interest and should be reduced for the following reasons: regulated compe tition has a high ratepayer cost and allocative and productive efficiencies are not achieved via regulation.

Second, under the topic of "Remaining Policy Concerns", Dr. Mayo stated that concerns of reduced regulation are exaggerated and stem from fears of 1) predatory pricing, 2) loss of universal service, 3) monopoly power in rural areas and 4) lack of meaningful competition. With the latter concern, Dr. Mayo holds "resellers", and not just "facilities-based carriers", provide meaningful competition. If problems arise with AT&T's reduced regulation proposals, Dr. Mayo holds targeted solutions could be applied.

Third, with regard to current regulatory policies, Dr. Mayo holds there is asymmetric regulation which results in four types of costs: 1) inefficient network utilization, 2) inefficient entry, 3) slowed innovation and 4) diverting competitive energies away from competition to regulatory compliance.

Fourth, with regard to policy alternatives, Dr. Mayo states that "service by service" and route specific detariffing is undesirable, and that "...asymmetric regulation is destined to be a 'worst of both worlds' policy for consumers."

Competition is Dr. Mayo's preferred policy alternative, but only if the following rules are in place restricting AT&T's provision of interLATA telephone service: 1) geographically equal milageband prices statewide, 2) services cannot be abandoned and 3) new services cannot be limited to specific market areas unless technologically limited. AT&T agreed to these commitments until the Commission removes them (TR 228).

MCC

The Montana Consumer Counsel (Mr. Al Buckalew) testified against reducing the current degree of regulation imposed on AT&T. The Montana Consumer Counsel's (MCCs) testimony follows.

First, regarding regulatory flexibility, the MCC stated that while competition promotes "economic welfare", sufficient competition does not exist to protect ratepayers if AT&T's proposal were adopted. MCC opposed AT&T's proposed CPI indexing and access charge pass through.

Second, regarding the current status of competition, Mr. Buckalew made a number of comments including: 1) workable competition does not exist statewide or by routes; 2) facility-based competition is key; 3) AT&T will use route-specific pricing to compete; 4) eliminating discounts for unequal access will squeeze competitor's profits; 5) excess profits, cross subsidization and predatory pricing are risks of deregulation; 6) brand loyalty gives AT&T a competitive edge; and, 7) AT&T's implicit reliance on contestable market theory is in error as the assumptions are not fulfilled.

In summary, MCC proposed no price changes in this docket until a category cost of service study is provided (MCC Exh. No. 3, p.9). However, MCC stated certain MTS mileage bands could be collapsed and that certain MTS, WATS and 800 prices could be increased. At the hearing, however, MCC proposed that the Commission "...act very soon..." to lower AT&T's prices (TR 386). MCC holds that the Commission should also require AT&T to produce a test year deregulated (private line) cost study. MCC's supplemental testimony also proposed changes in how carrier access charges are priced.

<u>MCI</u>

Microwave Communications Incorporated, (MCI), testified (Mr. Gates) on market- and route-specific detariffing/pricing. Due to concerns for cross subsidization and discriminatory pricing neither proposal is sound to MCI. On one hand, MCI holds that resellers do provide a check on the pricing of facility-based carriers. Then, MCI holds AT&T is the only facility-based interexchange carrier providing ubiquitous service in Montana: "While it is obvious that resellers such as MCI are subject to competition from AT&T, these resellers are not likely to be able to provide effective competition to AT&T." (MCI Exh. NO. 1, p.8)

MCI noted that the real danger to competition comes from the local exchange carriers' (LECs) provision of access to originate and complete calls. LECs should continue to be regulated. Finally, MCI holds, like MCC, that the record is incomplete to detariff AT&T in Montana. In contrast, MCI reiterated that its position on the federal regulation of AT&T is unchanged: AT&T should be deregulated (TR 276,318).

<u>NTS</u>

Northwest Telephone System's (NTS) testimony (Mr. John Slocum) was brief and reflected NTS's concern for its customers in Northwest Montana if AT&T were detariffed. NTS stated no carrier provides services equivalent to AT&T. Resellers exist (e.g., American Sharecom, Touch America, Allnet), but are not facility-based.

NTS advised the Commission to consider an alternative to AT&T's detariffing proposal. The alternative is to allow AT&T to offer interexchange service on a "price-listed" basis that mitigates the need for detariffing. The "price-listed" proposal differs from either of AT&T's proposals and would require AT&T to "...provide to the Commission a list of their proposed prices that would be available for the Commission or the public for viewing, but that these prices could be implemented whenever AT&T chooses." (TR 384)

NTS also attempted to clarify its position with regard to both AT&T's amended and supplemental testimony proposals. NTS holds the conditions/rules in AT&T's (Dr. Mayo's) testimony should apply equally to both AT&T proposals and not just the reduced regulation proposal (TR 383).

<u>COMMISSION</u>

For purposes of this order, the Commission interprets both AT&T's amended and supplemental proposals to be "reduced regulation" proposals. AT&T has suggested that its supplemental testimony proposal is a "detariffing" proposal (TR 382). As such, it clearly must meet the criteria of 69-3-807(3). Detariffing, to the extent requested in AT&T's supplemental testimony, will have to wait until further convincing evidence on the robustness of competition is forthcoming. The Commission, however, finds merit in partially granting AT&T's reduced regulation proposal. AT&T will be allowed to flow through changes in costs that relate to changes in carrier access prices.

In the following, the Commission will explain its reasons for partially granting AT&T's request. Generally, the Commission does not find convincing evidence to support reduced regulation beyond flowing through access charges. Reasons for this finding follow.

As a prefatory remark, the Commission has concern over the focus of the docket. All parties appear to assume that a competitive market structure is ideal and then proceed to explain how best to nurture emerging competition so that in a dynamic sense a competitive market prevails. In contrast, the Commission finds that the parties should have at least remained at step one of this analytical process long enough to discuss the natural market state or structure. That is, is a competitive structure least-cost over the long run, or is a monopolistic structure least-cost? In either case the issue of the degree of regulation is of concern. Hopefully, the next AT&T proceeding will address this concern.

The Commission's first reason for granting only part of AT&T's reduced regulation request is the dearth of evidence on the extent of competition in the marketplace. This finding involves MTS, WATs and 800 services. The overwhelming majority of testimony addressed MTS markets and competition. One could argue that the same sorts of competition to AT&T's MTS also provide effective competition to AT&T's WATs and 800 service. However, just how, for example, resold AT&T WATs is also competition to AT&T's WATs is unclear. In summary, AT&T's market analysis of WATs and 800 services was inadequate.

The Commission's additional reasons involve questions on the extent of existing and potential competition (see TR 173, 229, 311, 319, 340, 373). Regarding potential competition, AT&T holds WTCI can carry 100 percent of AT&T's interlata traffic. This point was refuted with the same degree of technical empirical data that supported AT&T's claim (TR 239,297). In any case, the claim begs the question as to the import of WTCI's capability to carry any and all inter-LATA AT&T traffic.

Also related to the degree of MTS competition is the ubiquity of competition. This issue has several dimensions. On one hand consumers can, as AT&T has correctly testified, purchase customer premise equipment (e.g., "speed dialers") that effectively allow equal access in terms of the relative inconvenience of number dialing.

On the other hand, there is the issue of the ubiquity of alternatives to AT&T's "one-plus" dialing in every exchange in Montana. This issue has two sub-parts. First, "equal access" will not be available to inter-exchange carriers (IXCs), as it is to AT&T, in every exchange in Mountain Bell's territory until more modern ESS equipment replaces older switching technology. This concern, however, is somewhat mitigated by the availability of e.g., speed dialers.

The second sub-part involves independent telephone company jurisdictions. It is the Commission's understanding, and not from an abundance of data in the current proceeding, that customers of certain independent telephone companies have no choice but to have AT&T carry their inter-LATA traffic. Although not based on data in the instant docket, it is a practical concern of the Commission's.

In this docket the Commission was appraised of changed regulation occurring in twelve other states. Why other states have moved in the direction of reduced regulation is of interest to the Commission in this docket. One proxy measure of the degree of MTS competition in a state involves the number of carriers appearing on "equal-access" ballots.

This proxy measure may, in turn, shed some light on the other state's reasoning for reduced regulation. In a late-filed exhibit, AT&T provided certain equal access ballot information for the twelve states with reduced regulation. AT&T also provided the same information for the State of Montana.

The information AT&T provided suggests differences exist between the degree of competition in Montana relative to the other twelve states. Some indicators follow. First, the average number of carriers per ballot, excluding AT&T, in the twelve states was 4.2. For Montana the average number was one. Second, the range and total number of carriers per state is also of interest. In Montana, the range was from one to two carriers. In the other twelve states the least number of carriers was five (5). Moreover, eight of the twelve states had eleven carriers or more, with a total of twenty-three carriers in one state.

While these facts do not present conclusive market data, they do reveal a difference in the degree of extant competition.

Montana on a relative basis does not have, on average, the same degree of competition as the twelve states with reduced regulation.

For the above reasons, the Commission finds that it would be premature to grant AT&T's reduced regulation proposal as presented in its supplemental testimony. The MCC also expressed concern over whether sufficient competition exists to protect ratepayers if AT&T's proposals were adopted. It remains for the Commission to discuss its reasons for not totally accept ing the reduced regulation proposal AT&T presented in its amended testimony.

As noted earlier, AT&T's amended testimony proposed flow through of carrier access charges (CACs) and rate adjustment based on changes in the consumer price index (CPI). The Commission will first state why it denies the CPI adjustment, followed by a discussion of the CAC flow through. In summary, the Company's CPI proposal lacked a thorough design. Problems the Commission perceived include the issue of to what prices (actually maximum allowable rates, MARs) would the index be applied, and second why the rate of technological change is not first netted from the consumer price index.

First, the Commission finds indexing of AT&T's maximum allowable rates to be problematic. For one, the MCC does not support such a pass through. To explain the Commission's concerns it is first necessary to understand that AT&T's revenue requirement can be broken down into two general areas: 1) costs related to access charge and 2) other costs. Access charges make up a majority of AT&T's revenue requirement. While not clear from the Company's amended testimony, the CPI adjustment would only be to the latter "other" category of costs (TR 242-246). That is, AT&T

has proposed that the traditional ratemaking process be changed to allow maximum allowable rate (MAR) increases to track CPI changes.

The Company's proposal to use the CPI raises a major issue. The CPI is not an index that reflects the changes in non-access costs AT&T will incur. First the CPI is not net of the rate of technological change the Company will experience with increases in its "other" costs. Nor does CPI indexing reflect cost changes to the "other" cost category that are unrelated to technological change. In summary, it is at best a crude device to automatically raise MARs. The Company also appeared to concede the import of netting the rate of technological change from the CPI (TR 243).

As an example of a related concern with the CPI, the Commission notes that the indexing is to AT&T's MARs. Given that AT&T already has downward price flexibility, this proposal must be to raise the MARs. In this docket MCI, a competitor of AT&T, testified that its pricing behavior is price following the dominant firm (TR 288). The extent to which AT&T then prices near its MARs would not appear to be impacted by MCI's price following behavior: In static net welfare economic terms all parties are worse off.

In the absence of a detailed proposal to flow through carrier access charges, it remains for the Commission to provide such parameters. First, anytime a local exchange carrier's (LEC's), carrier access charges change there must follow, within 60 days, a concomitant change in AT&T's MARs.

Second, the flow through of changes in carrier access charges to each of MTS, WATs and 800 services must be fully documented. That is, the most recently approved billing determinants for MTS, WATs and 800 Service must be the basis for MAR changes for the same services. Moreover, AT&T is not allowed to arbitrarily select certain prices to which the cost changes would be flowed through.

Rate Design Issues

Background

AT&T's present rates reflect the Commission's finding of an interim revenue deficiency of $1,688,000. In this final order the Commission increased this revenue deficiency to about 1.8 million dollars. In the following, the Commission will review AT&T's rate design proposal, intervenor concerns and the Commission's decisions.

AT&T

An exhibit in Mr. Maclay's testimony (AT&T Exh. No.5), provides AT&T's analysis of the straight-reprice revenue impacts of the Company's final requested revenue increase. The same exhibit shows AT&T's proposed prices that generate the proposed revenue levels for individual services. The prices and revenues generated, however, assume a final revenue requirement increase of $1,959,000, an amount roughly 9 percent greater than that finally authorized by the Commission. The following reviews AT&T's rate design proposals.

AT&T's proposed MTS rate design changes include collapsing the current mileage bands from nine to six in number, lowering the night/weekend discount from 60 to 50 percent and generally raising short haul initial and subsequent MTS rates. AT&T's proposed WATs and 800 service changes also include collapsing of the existing six-step declining-block structures to a three-step structure. Except for the first six hours of use AT&T proposes freezing or increasing the WATs and 800 prices.

Other tariff changes proposed by AT&T include: 1) raising Reach Out Montana additional hour rates from $7.50 to $9.00; and 2) changing Operator Surcharges. The operator handled Station to Station Surcharge would rise from $1.20 to $1.35. The Operator Calling Card Surcharge would rise from $0.50 to $0.60. Finally, AT&T proposed a new "operator handled conference service" of $6.00.

In the area of tariff administration, AT&T also proposed to reformat the Montana tariff. The result would be to merge the existing Network Services and Custom Network Services Tariffs in to one "Telecommunications Services Tariff" (Appendix 3 of the Company's application).

INTERVENORS

Intervenors submitted limited rate design testimony. The MCC's testimony comprised nearly all rate design proposals by intervenors. MCC's position on rate design relates to its position on a cost of service study. Mr. Buckalew stated that no prices should be changed until AT&T performs a category cost of service study and a private line study. Mr. Buckalew generally argues that because of the company's market power, prices should not be increased. AT&T's prices generally exceed its costs in Mr Buckalew's estimation. As noted earlier, Mr. Buckalew suggests certain MTS prices could be changed and that carrier access charge pricing should be revised.

COMMISSION

The remaining findings provide the Commission's decisions on rate design followed by requests to AT&T to produce certain additional information.

The Commission generally approves AT&T's proposed rate design and price changes modified somewhat to accommodate concerns the MCC expressed. Further, because the assumed revenue requirement in Mr. Maclay's testimony differs from that which the Commission finally approved, a residual service must be the source for balancing the allowed revenue requirement with prices in this docket.

First, the Commission approves AT&T's proposal to increase the surcharges associated with operator handled station to station calls and operator handled Calling Card calls. The Commission denies AT&T's proposal for a new, $6.00 surcharge for operator handled conference service. AT&T testified that these three surcharges would generate $216,144, but the Company's evidence supporting the revenue impact of the surcharge for operator handled conference service was insufficient. AT&T introduced a study of only one month in 1985 to support this proposal and its attempt at quantifying billing determinants was inadequate. The proposal is denied because AT&T did not introduce sufficient evidence to justify a new, $6.00 surcharge for operator handled conference service.

Second, the Commission denies AT&T's proposal to raise rates from $7.50 to $9.00 for each additional hour after the initial hour of Reach Out Montana. AT&T filed no evidence of the revenue related to this proposal and it filed no evidence on the number of monthly subscribers to Reach Out Montana or the revenue recovered from the $10.00 initial hour charge. Without this information, the Commission does not have sufficient evidence to adequately weigh the proposal.

Third, the Commission approves of the reduced discount to Night/Weekend MTS prices. This approval is not without certain comments and requests for documentation in the Company's revenue verification work papers. First, and assuming a change in carrier access pricing philosophy, this approval may have to be reversed in the near future. In turn, such a reversal depends in part on, for example, how AT&T's MIMIC model ascribes costs to on- and off-peak periods, as well as how the local exchange carriers also ascribe marginal costs to on- and off-peak periods. These issues will not be resolved in this docket, but will be addressed in the next access docket.

The $832,194 revenue increase associated with this reduced MTS discount must be substantiated in the Company's revenue verification work papers accompanying the compliance tariff filing to this order. The Company must show all billing determinants by mileage band and price block for the separate night and weekend periods. For the weekend period, the Company must show all underlying billing determinants assuming <u>no change</u> in the Sunday evening discount time change.

Fourth, the Commission also approves of AT&T's proposal to collapse the MTS mileage bands and implement the prices associated with Mr. Maclay's testimony. In its compliance tariff filing the Company must provide the billing determinants for each mileage band and for each time period assuming <u>no change</u> in the Sunday evening discount period. The Company must also provide the same billing determinants for each existing mileage band. As with all other price changes, a price out must document the accompanying revenue impact.

Fifth, the Commission approves of the Sunday evening discount time change from 7:00 to 5:00 P.M. The billing determinants by rate block and mileage band must be provided separately in the compliance tariff filing demonstrating the $59,099 revenue impact.

Sixth, the Commission finds merit in the changed "MATR" for 800 service from 60 to 30 seconds and the associated negative $1,869 revenue impact.

Finally, the Commission approves in part AT&T's proposal to collapse the declining-block structure of WATs and 800 service tariffs and to reprice both services. In doing so these two services are to be treated as the residual balancers to insure AT&T's final prices generate no more than the final approved revenue requirement in this docket. By making revenue adjustments to WATs and 800, the possible bill impact concerns raised by the MCC should be tempered. AT&T's proposed WATs and 800 Service prices are to be lowered on a uniform percent basis from the levels in Mr. Maclay's Schedule 1 by an amount that results in the Company generating the finally approved revenue requirement in this docket. In making a uniform percent reduction, AT&T is not to lower any price below cost as provided in the Company's August 3, 1987 late filed exhibit.

In another area, the Commission approves of the Company's proposal to merge and simplify its tariff. Appendix C of the Company's filing will comprise the Commission approved "Telecommunications Services Tariff."

Due to the significant rate design changes resulting from this Order, the Commission finds merit in AT&T providing certain information to its customers. AT&T is hereby directed to include as a "bill insert" a one page summary of the changed prices, discounts, etc., granted in this Order.

CONCLUSIONS OF LAW

1. AT&T Communications offers regulated telecommunications services in the state of Montana and is a public utility under Section 69-3-101, MCA. The Montana Public Service Commission has authority to supervise, regulate and control public utilities. Section 69-3-102, MCA. The Commission properly exercises jurisdiction over AT&T Communication's Montana operations pursuant to Title 69, Chapter 3, MCA.

ORDER

THEREFORE, THE MONTANA PUBLIC SERVICE COMMISSION ORDERS THAT:

1. AT&T Communications is granted authority to implement rates to generate additional revenues of $188,000 on an annual basis.

2. Rate schedules filed shall comply with all Commission determinations set forth in this Order.

3. The relief granted in this order is to be effective upon the filing and approval of tariffs reflecting the Findings in this Order.

DONE IN OPEN SESSION at Helena, Montana this 30th day of November, 1987, by a of 4 - 1 vote.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

CLYDE JARVIS, Chairman

HOWARD L. ELLIS, Commissioner

TOM MONAHAN, Commissioner

DANNY OBERG, Commissioner
Voting to Dissent

JOHN B. DRISCOLL, Commissioner

ATTEST:

Ann Purcell
Commission Secretary

(SEAL)

NOTE: Any interested party may request that the Commission reconsider this decision. A motion to reconsider must be filed within ten (10) days. See 38.2.4806, ARM.

SCHEDULE 1

	Per AT&T Rebuttal	TECOM Final Price Out	Interest Sync.	Total
REVENUES				
Intrastate Toll	$28,809			28,809
Contact Revenues	4,135			4,135
Miscellaneous Rev.	0			
Less: Uncollectibles	271			271
Total Revenues	32,673	0	0	32,673
EXPENSES				
Access Charges	20043	(6)		20,037
Billing & Coll.	2029			2,029
Depreciation	2,052			2,052
Maintenance	1,165			1,165
Operator Services	1,168			1,168
Marketing	1,032			1,032
Other General Engin.	426			426
Operating Rents	1,900			1,900
Accounting Services	283			283
Employee Benefits	563			563
Other General	454			454
Taxes - Non Income	1391			1,391
Exp. Charged Const.	6			6
Total Expenses	32,500	(6)	0	32,494
Net Operating Rev.	173	6	0	179
TAXES				
Federal Income Taxes	6	2	(1)	7
State Income Taxes	(125)		(0)	(125)
Total Income Taxes	(119)	2	(1)	(118)

Net Operating Income	$292	$4	$1	$297
Rate Base				
Plant in Service	$22,601			22,601
Depreciation Reserve	8,089			8,089
Prop. for Future Use	0			0
Materials & Supplies	3			3
Working Capital	1366			1,366
Unamort. Pre-'71 ITC	1			1
Deferred Inc. Taxes	3,755			3,755
Average Rate Base	$12,125	$0	$0	$12,125

SCHEDULE 2

Calculation of Income to Revenue Multiplier

Gross Revenues	100.0000%
Uncollectibles	0.8970%

Net Revenues	99.1030%
Gross Receipts Tax	1.8250%
Net for State Income Tax	97.2780%
State Income Tax	6.5663%
Net for Federal Income Tax	90.7117%
Federal Income Tax	30.8420%
Net Operating Income	59.8697%

Income to Revenue Multiplier	1.6703
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DISSENTING OPINION

I. Introduction

AT&T is a vastly different company today then it was prior to the divestiture of the Bell Operating Companies under the Consent Degree and Modified Final Judgement. No longer does this Commission regulate a "Ma Bell". Our review of AT&T is that of a long distance carrier providing service between the two Montana LATA service territories.

In this docket the Commission was presented with a case to set rates for AT&T service and also considered proposals to revise regulatory scrutiny.

I have cast a dissenting vote not because I disagree with the rates established or the Commission's approval of access charge pass-through. I concur that the rates are just and reasonable and that it is fair to allow rate adjustments without hearing as access charges are revised.

My disagreement is that the Commission could have adopted further lessening of regulation without sacrificing the public interest or neglecting its statutory responsibility. Just as AT&T has been transformed into a new company so must regulation be revised to fit changed circumstances. Although I do not endorse the specific plan offered by AT&T in its February 27, 1987 Amended Application I do support the concept of rate indexing and PSC monitoring through mandatory financial reporting. The following discussion will explain my position.

II. Rate of Return Regulation for AT&T Intrastate Operations is No Longer Appropriate.

Traditional rate base rate of return regulation has been a good regulatory mechanism for Commissions to judge rates and profits for most utilities. Those same forces that led to the formation of natural monopolies and government regulation of profits (i.e. high cost of market entry and huge capital requirements) made such a standard fair to shareholder and customer alike.

However AT&T is no longer a traditional utility. Much of its expensive plant went to the Bell Operating Companies in divestiture and most of AT&T's cost of providing service is operating expense rather than capital expenses. Moreover, AT&T no longer is the sole provider of service but only one of a number of companies or methods of providing inter-LATA toll services.

With the rather small investment in plant, traditional rate base rate of return regulation simply does not work well. With a small rate base, relatively minor changes in costs or sales can lead to fluctuating and volatile earnings. Unrebutted was the testimony of AT&T witness Steve Vinson that earnings to create the PSC authorized rate of return represent only 1.5¢ of each revenue dollar. Given the uncertainties of the market in which AT&T operates it is difficult to imagine earnings matching rate of return levels authorized by the Commission.

These earning volatility figures result in the need for frequent rate case proceedings. If underearning AT&T will seek regulatory relief. If overearning results the Commission will intervene or competitive toll providers will capture market share from AT&T.

Rate cases are the mechanisms used to review a company's revenues and expenses and to determine profit levels. In recent years rate hearings and processes have become much more sophisticated, giving regulators more information than ever to determine public interest rulings. However, the process is expensive, with thousands of dollars in legal and expert witness fees. In most cases even those substantial costs are dwarfed by the rates and revenues being contested and are indeed a justifiable and necessary expense. However, with the volatility of AT&T induced by the aforementioned problems (small rate base impacted by relative minor revenue or cost changes), it is my contention that the cost of regulation to the state and utility may outweigh the benefits. In this case months were spent haggling while only 300,000 dollars was at stake between the company request and recommendation of the major consumer intervenor.

Such changed circumstances beg for changes in the regulatory mode.

III. Competition Must be Considered

Due to federal initiatives, competitive forces are a new element in the utility business. Competition is emerging in the gas and electric business. In the long distance sector of telecommunications competition is a reality. Even in Montana where costs are high and markets are small, AT&T is being pressed for market share by well known carriers like MCI and Sprint and a host of other providers and resellers.

I heartily endorse the majority view that competition is not robust enough to deregulate or even detariff most of AT&T services. AT&T is certainly a price setter and retains market dominance which could result in monopoly abuse without regulatory oversight of both rates and conditions of service.

Yet competitive pressures are real and the Commission should consider it as one element of a host of reasons to grant some lessen regulation. Those who argue that more restrictive regulatory measures should remain in place until workable competition develops do a disservice to those customers most in need of protection. If AT&T remains constrained by regulatory lag, inflexibility in rate setting to respond to the market, and unnecessary administrative costs of regulation the result can only be erosion of their market. Presumably regulators are most concerned about the residual monopoly customer who may not have other alternative providers. Since most competitors seem most interested in high density and more profitable toll routes AT&T is likely to remain the carrier of last resort for rural residential customers. If AT&T loses profitable market share of the business and inter city accounts, they will be forced to recover more fixed overhead costs from remaining customers.

The Montana Telecommunications Act has set us on the course of promoting competition in telecommunications. Promotion should not be only for new entrants to the market but to insure traditional carriers like AT&T are afforded the conditions to participate fairly in the competitive market place. Currently none of the other toll providers operating in Montana are subject to regulation.

Although we may not have what economists call workable competition to obliterate the need for regulation, I believe sufficient competition does exist to help restrain AT&T and justify lessened regulation to the degree I advocate of indexing with concurrent PSC monitoring. By February of 1988, when Helena is converted to an equal access office over 50% of Mountain Bell's customers (128,377 of 254,889) will be able to subscribe to other providers with the ease of 1 + dialing. In Missoula AT&T retained 83.7% of the market after equal access balloting. Revenue losses could even be greater as many of those choosing other carriers are likely the highest toll users enticed by competitors.

There is every indication that AT&T views the competition as a very real threat. Despite the fact that most advertising costs are nonrecoverable in rates AT&T is spending enormous sums to convince Montanans to stay with AT&T in equal access balloting.

Even if we did not have MCI and other companies offering competition, AT&T must consider the impacts of their pricing policy due to less obvious forms of competition. Bypass is a real and growing force with the State of Montana joining major corporate forces like Montana Power and Burlington Northern who have abandoned the public switched network of AT&T for private installations. Banks and other large users seek to lower costs by purchasing less costly arrangements like private lines which impact AT&T earnings.

Conversely lesson regulation will not adversely impact alternative carriers or the state and national policy of fostering a competitive telecommunications system. By retaining regulatory oversight the Commission retains the ability to investigate and prevent predatory pricing.

As an aside, I must admit I am baffled by FOF 52 in which the Commission seeks to determine which economic model (a single provider or competition) is better. The Commission does not have the ability to dictate either. Inter-LATA competition is real and will remain. "Ma Bell" is gone forever as technology and politics rendered the monopoly unsustainable and archaic. Had I had my druthers AT&T would have remained an end to end provider, but there is no turning back now. The Commission would be well advised to concentrate on overseeing an orderly and fair transition to a fully competitive system rather than engaging in an academic question to which it cannot dictate a response.

In summary, present competition and the pursuit of competition cannot yet free the market from regulatory oversight but do provide justification for revising rate base rate of return regulation for AT&T's intrastate Montana operations.

IV Price Rather than Profits Can Be A Proper Regulatory Tool.

Given the unique circumstances of AT&T the standard regulatory scrutiny of authorized earnings levels has little effect on the prices Montana customer will pay. As AT&T witness Steve Vincent points out in his prefiled amended testimony a 100 basis point change in authorized rate of return results in a revenue requirement change of only $71,000 and a 5% change in authorized rate of return results in only a 1% change of total revenue requirement.

Given the exhaustive review of AT&T just completed in this docket I conclude the Commission can have confidence of the rates approved in this order as a proper point to start indexing.

Consumers are interested in the prices they pay, not the underlying costs. Now that an acceptable basis has been established the Commission should feel comfortable in reflecting that concern by focusing on prices. Indexing (while leaving the door to PSC intervention if conditions warrant) would assure ratepayers of reasonable prices.

V. Comments on Indexing

I support the concept of indexing, but I definitely do not endorse the specific AT&T proposal to use the CPI as the indexing standard. One of my reservations about indexing is that the index may not reflect actual changes in costs of providing telecommunication services and may fail to take into account increases in productivity and cheaper technology. Had the Commission been more inclined to adopt indexing I believe further study could have overcome these shortcomings. Since the threshold was not passed little work was done in this area, but I can think of several possible solutions:

1) Discounting the CPI by some percentage to make more reflective of the telecommunications industry rather than the economy as a whole.

2) Adopting some other index more appropriate to the telephone industry.

3) Direct staff, MCC, and AT&T to study the question and negotiate an acceptable index.

However given the fact that toll service technology is pushing costs down as fiber optics becomes the standard there is reason to believe that indexing could lead to higher rates than necessary. The answer to that lies in the monitoring process that I believe must be a mandatory adjunct to indexing. If the Commission has reason to believe costs have fallen dramatically or AT&T is earning excessive profits the PSC has the inherent ability to investigate rates.

I also believe the market place offers some protection from over earnings. If costs decline and AT&T continues to raise rates through indexing I believe competitors would step in and capture a greater share of the market so the system would offer some policement.

VI. A Proposed Alternative

I have tried to build a case that the pass through of access charges in the Commission's order does not go far enough. An indexing proposal with concurrent financial reporting could have been authorized based on the record in this case. Since I have cast a dissenting vote I feel an obligation to describe a framework for an acceptable alternative that I could endorse.

1) The appropriate index should be established through negotiation between PSC staff, MCC, and the company subject for approval by the Commission.

2) Indexing or rate changes would be triggered twice a year.

3) Financial data would have to be supplied quarterly 30 days prior to the trigger date.

4) No index prompted rate change could take place if AT&T were earning at or above the authorized rate of return.

5) AT&T would be required to file not only financial data but also an annual report on capital investment. (To insure Montanan's get their fair share of fiber investment recently announced by AT&T).

6) This proposal would sunset in 30 months and the Commission would invite comments from all interested parties on this experiment. Continuation of this departure from traditional ratemaking standard would require an affirmative vote of the Commission.

I have made this last recommendation as I have tread new ground and I believe the genius of Montana's regulatory system is our accountability to ratepayers and voters. Hence, I believe should be held accountable for this plan before my present term of office expires.

VII. Summary

Divestiture has irrevocably changed the world of telecommunications. Although the picture is clearer today than on January 1, 1984 the status of telecommunications is still evolving towards competition. Regulators should not be making dramatic changes, but at the same time traditional modes of regulation serve neither the industry nor consumers very well.

The policies I endorse in this opinion represent a moderate change in regulation consistent with public interest criteria, but innovative enough to be an acceptable transitional regulatory structure. I have sought to strike a balance between those interests who refuse to recognize the dramatic changes in telephony and those which fail to realize there is a continuing need for consumer protection and regulatory oversight.

Danny Oberg, Commissioner